Brown ADVISORY
Thoughtful Investing.

SUSTAINABLE INVESTING

ELEVATING THE "G" IN ESG

Author: Victoria Avara, ESG Equity Research Analyst

theAdvisory Investment Insights and Thoughts from Brown Advisory

ESG research—the rapidly evolving field that seeks to add environmental, social and governance factors to the investment equation—has received an immense amount of focus in recent years, from every corner of the investment industry.

But the lion's share of the attention, passion and discussion has revolved around environmental topics like climate change and social topics like racial injustice. Governance—the "G" in ESG—gets very little attention in comparison. This cannot stand!

I get it, I do. I am a former auditor and an avid student of corporate governance, and even I can start to go cross-eyed after reading too much about board declassification and other arcane concepts. **But in many ways, governance is the key that unlocks the ESG equation, and a critical driver of corporate performance AND corporate responsibility.** Governance is a powerful motivating force for a company—the collection of rules and procedures, incentives and penalties, carrots and sticks that turn strategy into reality. Simply put, companies have to get governance right if they want to successfully implement their sustainability strategies over the long term.

Corporate governance has tended to evolve in waves in recent history, with each wave a response to major disruptions in market or economic conditions. **We are currently in the midst of another of these waves.** The next era of corporate governance, in our view, will be shaped by two powerful and interconnected economic forces:

1. intensifying global challenges and instability (most recently exemplified by the COVID pandemic, an ongoing reckoning with racial injustice and Russia's invasion of Ukraine), and
2. the call for effective governance of corporate sustainability strategy, as not just a way of doing good, but as a powerful driver of long-term financial results.

At Brown Advisory, we aim to invest in forward-thinking companies that, in our view, treat governance as an opportunity, not a chore. In particular, we are attracted to companies that are expanding their governance approach to try and embrace a broader array of stakeholders. We believe that such companies may find themselves far better positioned to compete in the future than companies who choose to "go it alone" and forgo more modern approaches to collaborative business planning.

Background

Effective governance is, in our view, the bedrock of corporate resiliency. It is the totality of systems that govern how a corporation is controlled and managed, and how the interests of employees, management, ownership and other stakeholders are protected and reconciled.

Good corporate governance can mitigate the risk of misconduct, accelerate business opportunities, and build trust amongst stakeholders. Conversely, failures can have a devastating effect on a company, our economy, and society more broadly. There is no cookie-cutter governance solution that will work in every situation, but **experts and regulators around the world consistently seek to uplift key aspects of responsible corporate governance, such as independence, accountability, responsibility, integrity and transparency**.

The term "corporate governance" appeared in the Federal Register for the first time in 1976, and the field evolved from there in an ongoing effort to adapt to rapid changes in society, technology and capital markets. Today's governance landscape is heavily influenced by the two biggest financial shocks of the 21st century:

- The breakdowns in governance and ethics at Enron and Worldcom in the early 2000s triggered meaningful change. The Sarbanes-Oxley Act of 2002 elevated debates around corporate responsibility and enhanced the integrity of financial reporting. Among other outcomes, the legislation created the Public Company Accounting Oversight Board, which established a standard for auditor independence and addressed other challenges.

- The 2008-09 credit crisis showed that further governance reform was needed in the U.S. The Dodd-Frank Act of 2010 tightened standards and oversight of banks and put in place a multitude of institutional changes, such as new listing rules for the New York Stock Exchange.

Sarbanes-Oxley and Dodd-Frank both helped elevate the priority of responsibility, transparency and integrity in U.S. corporate governance. As long-term investors, these shifts in the landscape are important for us to understand—and all signs seem to indicate that we are on the cusp of another.

The Next Wave

Specifically, we believe that two major challenges could reshape corporate governance for decades to come:

1. **Increasing Global Crises and Risks:** Our interdependent globalized society is under increasing threats on multiple fronts. The COVID pandemic disrupted the social and economic fabric of the world, and the more recent invasion of Ukraine by Russia upended energy markets and created a global food and refugee crisis. These recent events can be viewed as indicators of larger issues, such as the rise of authoritarianism around the world, and the dangerous degree of vulnerability that has been exposed across global supply chains. At least for some companies and sectors, the chaos of recent years will almost certainly lead to governance changes that seek to address the changing risk equation.

   What keeps us up at night is the governance risk created by desperation. Companies will likely be under intense pressure over the next several years to solve for entirely new crises and risks while continuing to meet quarterly expectations. The deeper the challenge an executive team faces, the more tempting it becomes to cut corners, so it is imperative for governance standards to keep pace with market realities. (This is a point that former Sen. Sarbanes shared with me personally, almost ten years ago—I would be remiss if I didn't shout out his unyielding passion for investor protection in this article!)

2. **The Need for Governance of Corporate Sustainability:** On top of the acute crises mentioned above, companies are also grappling with chronic sustainability issues stemming from climate change, racial inclusion and a host of other challenges. The emergence of sustainability as a core element of corporate strategy will likely require broad changes in how corporate governance is practiced and regulated.

   Increasingly, sustainable business strategies—whether they drive the company's revenue, help it cut costs, or gain market share from competitors—are viewed as positive drivers of company performance. Consumer attitudes are changing, the renewable energy cost curve continues to decline, and customers increasingly want and need solutions to reduce energy, water and natural resource consumption. These factors and many others have been tailwinds for many companies that are seeking to drive shareholder value through sustainable initiatives.

   However, we share the concerns of many observers that most boards and executive teams are not fully armed yet when it comes to monitoring or evaluating the success or failure of their sustainability strategies. In its annual survey of corporate directors, PriceWaterhouseCoopers found that while 64% of directors said that ESG was linked to their company's overall strategy, only 25% of them said they understood those risks well.

   Many companies face the challenge of reinforcing their boards with appropriate expertise, especially for topics such as climate change that are outside of most boards' traditional purview. At one time, these ESG issues were not core responsibilities for companies. But they are now, and fiduciary oversight needs to adapt accordingly. Currently, we are seeing this play out as the SEC seeks to require climate-related risk reporting from U.S. public companies. If those regulations are adopted, they will produce a notable new oversight requirement—and by association, a minimum expertise requirement—for all public company boards.

What Are We Doing?

With regard to governance—and in our investing work in general—we tend to be more interested in things that a company can control, and less so in things they cannot. Simplistically, the SEC's decision about climate disclosure or other governance rules is unlikely to affect our investment choices much, but the way that companies ***respond*** to those rules—how they conduct themselves with customers, competitors, investors, employees and their own boards in developing climate strategy—is meaningful and important to us. For our strategies that lean heavily on ESG research, we are most interested in companies that are creating fully fleshed-out sustainable businesses—not just reacting to legal requirements, but truly learning from sustainability challenges and proactively building governance structures that we believe will foster long-term resiliency.

We also seek to encourage companies to improve their governance practices through engagement. For example, we engage extensively with companies, bond issuers and a host of related stakeholders on strategies to address climate change. In recent years, we have partnered with groups and initiatives such as TCFD, CDP and the Science-Based Target Initiative to encourage stronger emission reduction targets and firmer structure to monitor results. We believe this groundwork will be a key foundation for many companies as they adapt their procedures to comply with new SEC climate disclosure rules (if they become law).

Because of the many years we have spent engaging with our portfolio companies, those companies increasingly ask us to provide feedback when they are considering new sustainable initiatives. In a recent example, one of our portfolio holdings instituted an annual governance outreach to deepen shareholder engagement and invited our participation. The company demonstrated its devotion to sustainability, in part, by its proactive solicitation of stakeholder feedback—a trait we view favorably.

This company announced that the process was instrumental in guiding its new "more modern and shareholder-friendly governance practices." Planned changes include declassifying director election terms (i.e., terms are no longer staggered, all directors stand for election in the same year), separating the CEO and board chair roles, implementing executive incentive compensation based on return-on-capital metrics, establishing board oversight of corporate sustainability, and taking steps to ensure the board composition is periodically refreshed.

Despite the uncertainty that lies ahead, we are incredibly encouraged by our portfolio companies that are tackling this governance challenge proactively, but there are plenty of companies that are not taking these important steps. To us, the opportunity as investors is to use governance research to separate the wheat from the chaff when selecting investments. We believe strongly that the companies who are doing this governance work now will be far better positioned to compete in the future. And we are equally convinced that investors who can look past the mundane reputation of corporate governance and see it for what it is—the roadmap for running a successful company over the long term—will be better prepared to choose wise investments that are built to last.

The views expressed are those of the author and Brown Advisory as of the date referenced and are subject to change at any time based on market or other conditions. These views are not intended to be and should not be relied upon as investment advice and are not intended to be a forecast of future events or a guarantee of future results. Past performance is not a guarantee of future performance and you may not get back the amount invested.

ESG considerations that are material will vary by investment style, sector/industry, market trends and client objectives. Ours strategies seek to identify companies that we believe may have desirable ESG outcomes, but investors may differ in their views of what constitutes positive or negative ESG outcomes. As a result, our strategies may invest in companies that do not reflect the beliefs and values of any particular investor. Our strategies may also invest in companies that would otherwise be screened out of other ESG oriented portfolios. Security selection will be impacted by the combined focus on ESG assessments and forecasts of return and risk. Our strategies intend to invest in companies with measurable ESG outcomes, as determined by Brown Advisory, and seek to screen out particular companies and industries. Brown Advisory relies on third parties to provide data and screening tools. There is no assurance that this information will be accurate or complete or that it will properly exclude all applicable securities. Investments selected using these tools may perform differently than as forecasted due to the factors incorporated into the screening process, changes from historical trends, and issues in the construction and implementation of the screens (including, but not limited to, software issues and other technological issues). There is no guarantee that Brown Advisory's use of these tools will result in effective investment decisions.

The information provided in this material is not intended to be and should not be considered to be a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell, or hold any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. To the extent specific securities are mentioned, they have been selected by the author on an objective basis to illustrate views expressed in the commentary and do not represent all of the securities purchased, sold or recommended for advisory clients. The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This piece is intended solely for our clients and prospective clients, is for informational purposes only, and is not individually tailored for or directed to any particular client or prospective client.

www.brownadvisory.com